RTO/ISO Credit Principles and Practices (AD21-6-000)
Credit Reforms in Organized Wholesale Markets (AD20-6-000)

Prepared Technical Conference Remarks of R. Scott Everngam, CFA

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Introduction

Good afternoon and thank you for inviting me to participate on this panel. My name is Scott Everngam, and I am the President and Founder of Blue Horseshoe Energy, LLC, an independent management consulting firm primarily advising regulated electric utilities. Today I am speaking based upon my experiences with Wall Street trading markets as a Chartered Financial Analyst, and as a subject matter expert who worked directly on many credit policy dockets for the three eastern RTOs/ISOs during my FERC career, beginning with the 2010 Credit Reforms Final Rule in Order No. 741.[1] On staff, I worked on many contested market design dockets involving FTRs and virtual transactions, particularly those involving PJM. Therefore, these prepared remarks represent my independent views on RTO/ISO credit practices, and are not on behalf of any particular market participant.

This panel will address the impact of market design on credit risks in these organized FERC-regulated markets, particularly as to how they impact the FTR markets and other trading products such as virtual transactions. The market design of such products differs among the RTOs/ISOs, and these differences in contract lengths, trading locations, and auction calendars have led to credit policy differences. My hopes are that common credit policy principles can enhance the robustness and liquidity of financial trading and improve price discovery, while at the same time minimizing market participant costs and reducing the risks of socializing the costs of another major default in the FTR markets.

Impact of Current Market Design and Liquidity on Credit Risk

The first questions ask how current RTO/ISO market designs of FTRs and other similar market products shape credit risk policy and impact the liquidity that help determine these credit risks. Regardless of the RTO/ISO-specific terminology for these similar products, such as for FTRs, CRRs, or TCCs (all of which I shall reference as FTRs), the overall risks are most influenced by the volume of positions held, the time length of these contracts, and if there exists sufficient liquidity to determine prices and enable market

[1] *Credit Reforms in Organized Wholesale Electric Markets*, Order No. 741, 133 FERC ¶ 61,060 (2010), *order on reh'g*, Order No. 741-A, 134 FERC ¶ 61,126 (2011), *reh'g denied*, Order No. 741-B, 135 FERC ¶ 61,242 (2011).

participants to move and out of these products efficiently. I strongly believe that credit policies should ensure there are only adequately capitalized market participants in the FTR and virtual trading markets, not only on an initial analysis, but closely monitored on an ongoing basis. I believe that, within reason in minimizing credit defaults, maximizing the number of market participants should enhance these markets by providing liquidity sufficient to trade in-and-out of positions efficiently, and to provide adequate pricing data so the credit departments can implement more sophisticated mark-to-market analyses.

Potential Impact of Potential Market Design Changes on Credit Risk

The next questions address potential ways the Commission can strike an appropriate balance between how credit policies can protect the wholesale energy markets from defaults, while ensuring sufficient participation and ease of entry to produce sufficient competition. While I would not go so far as to allow the potential credit risks to drive market design, I believe it would be beneficial for the RTOs/ISOs to consult with the credit experts when they consider and propose market design changes and debate them with their market participants during their stakeholder processes. Consistent with many market design experts, I think of virtual products such as INCs, DECs, and UTCs as day-ahead or even hourly financial products, like a single day FTR, which fall at the low end in the credit risk spectrum. Therefore, my focus would be on market design revisions which permit a sufficient amount of biddable trading points and paths for FTRs and related products, allowing market participants to contract between the necessary points to hedge the price risks along such paths. This design would consider the liquidity provided by financial participants that take the other side of the trades, including for counterflow FTRs. Finally, the length of contracts and frequency of FTR auctions impact the ability for markets to provide adequate pricing information for mark-to-market functions. These are critical to shape RTO/ISO credit risk and determine appropriate levels of collateral.

Coordination of Market Design among Risk Departments and Risks

The next question asks whether greater coordination with the credit risk departments within all the RTOs/ISOs during the market design process would help reduce overall market risks. While it is a given that sharing Know Your Customer and credit profiles among each RTO/ISO should reduce credit risks, the concept of taking these risks into account when developing the market rules should be another positive step to reduce risks further. My assumption is that the Chief Risk Officer or a designee with market design and/or trading experience with FTRs and virtual trading products would participate in the various stakeholder processes to share best practices and lessons learned. To be clear, in no way would I recommend that each RTO/ISO must share a standard market design for

its financial trading products, or that FERC should require it. However, the coordination of RTO/ISO market designs to take into account default risks with the inputs of the credit risk departments experienced in such products should prove beneficial to all stakeholders.

Potential Benefits and Drawbacks of Third Party Clearing

The final questions address the potential benefits and drawbacks to the RTOs/ISOs and market participants of the third party clearing of FTRs, in contrast to performing that function internally by the RTOs/ISOs using models similar to those employed by the third party exchanges. My position on this issue has evolved towards handling clearing within the RTOs/ISOs themselves, given the increasing sophistication over time of their credit risk departments. They have been hiring Chief Risk Officers and sophisticated credit staff, ramping up the core credit office competencies that unfortunately were lacking in the not-too-distant past. It has provided me some comfort learning that the RTOs/ISOs are sharing information among themselves regarding Know Your Customer practices and the levels of collateral posted in each RTO/ISO.

While I believe that third party clearing houses generally are capable of providing such services in lieu of the RTOs/ISOs, I am concerned that the costs to market participants annually could approach the costs of a major default, so I am not yet convinced that the cost-benefit analysis of outsourcing this function works. Another drawback is that third party clearing houses are not likely to understand fully the market design risks of FTRs and other trading products as well as the RTOs/ISOs, who could keep costs lower by their better understanding of the risks of these products. Importantly, the CFTC vs. FERC jurisdictional issues once again could be raised if the clearing function moves to third party clearing houses regulated by the CFTC, not this Commission. Historically, the Commission has shown a strong preference to maintain full jurisdiction over all elements of its wholesale energy markets, and I believe having the RTOs/ISOs continue to develop more sophisticated internal credit and clearing functions may better serve this preference.

Conclusion

I am very pleased that the Commission is holding today's technical conference on these important credit issues. I hope that the result is that the RTOs/ISOs continue to become more sophisticated in developing the needed credit competencies to support robust FTR and virtual trading markets. This concludes my opening remarks, and I look forward to responding to the questions to this panel from the Commissioners and FERC staff.